DEPARTMENT OF STATE REVENUE

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FIRST SUPPLEMENTAL LETTER OF FINDINGS: 96-0317
Sales and Use Tax
For The Period: 1992 Through 1994

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ISSUES

I. Sales and Use Tax: Blood Shield Statute and Taxation

Authority: IC 16-41-12-11; IC 29-2-16-1; JKS. Sr. v. Armour Pharmaceutical Co., 660 N.E.2d 602 (Ind. App. 1996)

The taxpayer protests the Department's interpretation of IC 16-41-12-11 and its effect on taxation.

II. Sales and Use Tax: Manufacturing Exemption

Authority: IC 6-2.5-5-3; 45 IAC 2.2-5-8; Indiana Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520 (Ind. 1983); Harlan Sprague Dawley v. Indiana Dept. of State Revenue, 605 N.E.2d 1222 (Ind. Tax 1992); Mid-America Energy Resources, Inc. v. Indiana Dept. of State Revenue, No. 49T10-9504-TA-00038, May 22, 1997, (Ind.Tax 1997)

The taxpayer protests the imposition of sales/use tax on equipment.

STATEMENT OF FACTS

The taxpayer operates a plasmapheresis center where whole blood is withdrawn from human donors and separated by a centrifuge into source plasma and red blood cells. The red blood cells are returned to the donor. The source plasma is tested, frozen, packed and shipped to pharmaceutical companies where it is further processed and components such as gamma globulin and AHF are extracted for use in vaccines and other medicines.

I. Sales and Use Tax: Blood Shield Statute and Taxation

DISCUSSION

The Department audited the taxpayer in February 1996, and assessed use tax on items the taxpayer purchased for its business. The Department disallowed manufacturing exemptions, concluding that drawing whole blood and separating source plasma from the blood is a service and not a manufacturing process. The taxpayer, however, asserts it is entitled to the manufacturing exemptions, and supports its position with a finding the Department made after a 1987 audit, which states that the taxpayer's business involves a manufacturing process. *See, LOF 87-0610 Issued November 22, 1988, at page 2.*

The Department ruled on the taxpayer's present protest on July 9, 1997, with the Department finding that the taxpayer was providing a service. The Department relied not only on the auditor's argument, but also pointed out that by statute the taxpayer had been defined as a service provider. The Department noted that between the earlier Letter of Findings relied upon by the taxpayer and the present protest, the Indiana Legislature had enacted, in 1993, IC 16-41-12-1 (the so-called "Blood Shield Statute"). The statute reads, in part:

> (1) The procurement, processing, distribution or use of whole blood, plasma, blood products, blood derivatives, or other human tissue... by a bank, storage facility, or hospital; *and*
>
> (2) injection, transfusion, or transplantation of any of the human tissue listed in subdivision (1) into the human body *by a hospital, physician or surgeon,* whether or not any remuneration is paid;
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> is the rendition of a service and not the sale of the product. Such services do not give rise to an implied warranty of merchantability or fitness for a particular purpose, nor do the services give rise to strict liability in tort. (Emphasis added)

The "blood shield statute" was designed to protect manufacturers from strict liability in tort under common law. The Department's argument is twofold: (1) the taxpayer came within the scope of the statute, and (2) the legislature's intent was not only to protect manufacturers from tort liability but also to change its tax liability classification. With regard to the latter, the Department relied on a similar blood shield statute in Kentucky. In Revenue Cabinet, Commonwealth of Kentucky v. Plasma Alliance, Inc., 794 S.W. 2d 639 (Ky. App. 1990), the Kentucky Court of Appeals found that although source plasma could not, without further processing, be injected into the human body, plasmapheresis centers were, nevertheless, covered by the Kentucky blood shield statute and the appellant's business was deemed a service and not entitled to an exemption for manufacturing equipment.

The taxpayer's argument is threefold. First, the taxpayer argues that it does not come within the scope of the statute. Second, that even if it did come within the scope, the statute must be construed narrowly to apply only to torts, not

tax law. And the third argument is against the auditor. The auditor found the taxpayer to be engaged in a service without relying on the "blood shield statute." The auditor's arguments are discussed in part two of this letter of findings.

The taxpayer argues that it does not come within the scope of the statutory definition of a blood bank, storage facility, or hospital. A blood bank is defined by IC 16-41-12-2 by reference to IC 29-2-16-1. That definition is as follows:

> (a) "Bank or storage facility" means a facility licensed, accredited or approved under the laws of any state for storage of human bodies or parts thereof.

This definition must be read in conjunction with IC 16-41-12-11(a)(2), which states that the bank or storage facility must also inject, transfuse, or transplant human tissue. The taxpayer does not sell a product for direct transfusion.

The process is as follows. When a donor comes in, the taxpayer inserts a hollow needle into the donor's arm to remove whole blood. That whole blood is moved via tubing into a bowl in the center of the Haemonetics machine that the taxpayer uses to produce "source plasma." Anticoagulants are added to the blood to prevent clotting and then, by centrifugal action, the blood is spun to separate out the plasma from the red blood cells in the blood. Once the source plasma is extracted from the blood, the red blood cells are returned to the donor. This is not a therapeutic operation for the donor--the taxpayer is producing source plasma. Source plasma is shipped to pharmaceutical companies for further processing and is used in the making of vaccines and other medicines.

With regard to whether or not the taxpayer comes within the scope of the "blood shield statute," the taxpayer cites JKB, Sr. v. Armour Pharmaceutical Co., 660 N.E.2d 602 (Ind. App. 1996). In JKB, Sr. v. Armour Pharmaceutical Co., the Appellate Court found that a pharmaceutical company cannot invoke the blood shield statute to limit its tort liability--since it was selling a product, albeit derived from tissue, not providing a service. The taxpayer argues that it does not provide a service or transfusion and that its situation is analogous to a pharmaceutical company. The taxpayer's product, source plasma, cannot be injected back into the human body. The source plasma is used by pharmaceutical companies for further manufacturing. The red blood cells, are returned to the donor concurrently as the source plasma is removed. This process has no therapeutic function for the donor. The return of the donor's red blood cells, concurrent with the separation, is done merely for convenience.

Two things must be noted with regard to the Department's reliance on Revenue Cabinet, Commonwealth of Kentucky v, Plasma Alliance, Inc. First, the Kentucky case is not binding law in Indiana. But even as persuasive evidence the Kentucky blood shield statute lacks probative value for the Department, since it is broader than Indiana Code 16-41-12-11. The Kentucky statute states that under its definition:

> Procurement, processing, distribution or use of whole blood, plasma, blood products, blood derivatives... is declared to be, *for all purposes*, the rendition of a service. KRS 139.125 (emphasis added)

Indiana Code 16-41-12-11(a)(2) states "injection, transfusion, or transplantation of any human tissue... is the rendition of a service and not the sale of a product." Indiana Code 16-41-12-11(a)(2) lacks the "for all purposes" clause. The Kentucky statute predates the Indiana one, and given the close similarity of the two statutes in other respects, it is reasonable to assume that the Indiana statute was modeled on the Kentucky one--with the relevant language "for all purposes" excised. There is also other evidence that the legislature intended the Chapter 12 (blood shield statute) to apply only in the area of torts. For instance, IC 16-41-12-2, in defining "bank", limits its meaning: "[a]s used in *this* chapter, 'bank' has the meaning...."

FINDING

The taxpayer's protest on this issue is sustained.

II. Sales and Use Tax: Manufacturing Exemption

DISCUSSION

Even if the taxpayer does not fall within the rubric of the blood shield statute, an issue still exists as to whether or not the taxpayer is a manufacturer--irrespective of IC 16-41-12-11. In general, all purchases of tangible personal property are taxable. However, IC 6-2.5-5-3 and 45 IAC 2.2-5-8 provide that manufacturing machinery, tools, and equipment are exempt for sales/use tax if the person acquiring the property acquires it for the direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining or finishing of other tangible personal property. The taxpayer, *contra* the auditor, argues that it is a manufacturer.

In order for the exemption to be applicable the taxpayer must show that they are engaged in "production." (See, Mechanic's Laundry & Supply, Inc. v. Dept. Of State Revenue, 650 N.E.2d 1228 (1995)). Production can occur through manufacturing, processing, or other activities listed in the exemption. Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520 (1983).

Various types of activities have been found by Indiana courts to be "production" under IC 6-2.5-5-3. A triad of cases, Indiana Dept. of State Revenue v. Cave Stone, Harlan Sprague Dawley v. Indiana Dept. of State Revenue, and Mid-America Energy Resources, Inc. v. Indiana Dept. of State Revenue, must be analyzed to determine whether or

not the taxpayer meets the threshold question as to whether the taxpayer is engaged in production.

In Cave Stone the Indiana Supreme Court acknowledged the "essential and integral" test as a means for determining whether or not the double direct test is met. The Court recognized that the whole production process must be focused on. In Harlan Sprague Dawley the Tax Court ruled that "production" occurred where rats were bred in a sterile environment to create offspring with particularized, desired characteristics. In rejecting the Department's position that there was no processing because no new product distinct from its input emerged, the Tax Court ruled that the taxpayer did create something new, namely, viral free rats, which were a valuable good for research laboratories. The Tax Court also pointed out that "production is viewed expansively as all activity directed to increasing the number of scarce economic goods." And finally, in Mid-America Energy, the Tax Court similarly found that the taxpayer's cooling of water constituted production of other tangible personal property. The cooling process created a significant change in the properties at the molecular level.

Given the prior Letter of Findings (87-0610ST), where the Department found the taxpayer to be a manufacturer, the relevant case law, and the fact that source plasma has many different qualities from whole blood, the taxpayer's protest on this issue must be sustained. The taxpayer is a manufacturer.

However, a separate issue exists as to when the production process begins and when it ends. The taxpayer argues that the production process begins with initial screening of the donor. The taxpayer states that the screening and testing process constitutes an integral part of the production process and should be exempt from sales and use tax. In addition to donation equipment and supplies, the taxpayer would like to exempt pre-donation equipment and supplies, such as film for pictures, identification cards (I.D.), HCT centrifuges, and refractor controls; the taxpayer also wants to exempt equipment used in destructive testing.

FINDING

The taxpayer's protest is sustained in part, denied in part. The taxpayer's argument that it is a manufacturer is sustained. However, the taxpayer's contention that pre-donation equipment is exempt is denied. The taxpayer has indicated that its process can be viewed in four steps: (1) pre-donation/reception area, (2) donation and plasma segregation, (3) packaging and freezing, and (4) testing and shipment. Items protested which fall under step one--pre-donation, are denied. The taxpayer's exempt process begins when the plasma processing begins, *i.e.* the withdrawal of blood from the donor. Equipment and supplies falling under step four are also denied, since the testing described is destructive in nature and is not exempt under 45 IAC 2.2-5-8(I). This finding is consonant with Letter of Findings 87-0610.